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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 857

LIDGERWOOD MANUFACTURING CO.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

FRED R. TAUSSIG,
Counsel for Petitioner,
324 Connecticut Avenue, N. W.,
Washington 6, D. C.

Of Counsel,
GOODWIN, ROSENBAUM, MEAGHER & WHITE,
Washington 6, D. C.

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SUPREME COURT OF THE UNITED STATES

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No.

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Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable The Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Lidgerwood Manufacturing Co., prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case on January 17, 1956.

Opinions Below

The Opinion of the Tax Court of the United States, filed August 31, 1954, is reported in 22 T. C. 1152 and is printed as Appendix D hereto, *infra*, p. 17. The Opinion of the United States Court of Appeals for the Second Circuit has not yet been printed in the official reports but is printed here as Appendix B, *infra*, p. 11.

Jurisdiction

The Opinion and Judgment of the United States Court of Appeals for the Second Circuit were entered on January 17, 1956. Appendix B, *infra*, p. 11 and Appendix C, *infra*, p. 16. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Question Presented

Where wholly-owned subsidiaries of a parent corporation are indebted to the parent and those debts become worthless and uncollectible in the taxable year, does the parent corporation lose the right to the bad debt deduction under Section 23(k)(1)[1] simply because it voluntarily cancels the worthless debts?

Statute Involved

The applicable portion of the pertinent statute is set forth in Appendix A, *infra*, p. 11.

Statement

The undisputed facts are briefly as follows:

The petitioner, Lidgerwood Manufacturing Co., is a New York corporation with offices in New York City. It maintained its books and records and filed its Federal tax returns for the year 1946 on the calendar year basis using the accrual method of accounting. In 1946, the petitioner had two wholly-owned subsidiary corporations, known respectively as Superior and Dutchess. On October 31, 1946, Superior owed petitioner, its parent, some $411,000.00 and on that date the petitioner voluntarily cancelled $300,000.00 of Superior's indebtedness, at the same time receiving 3,500 shares of Superior's common stock. On three occa-

[1] Reference is to the Internal Revenue Code of 1939 as amended.

sions during 1946 the petitioner likewise cancelled debts owed to it by Dutchess in the aggregate amount of $350,000.00, receiving in exchange additional shares of Dutchess' common stock upon the occasion of each cancellation.

Each of the debts referred to was uncollectible on the date when cancelled. It may be assumed also that the subsidiary-debtors were insolvent both before and after the cancellations.[2]

At the time of the cancellations appropriate book entries were made by the respective corporations reflecting, in the case of the petitioner, an elimination of the subsidiaries' indebtedness in the amount cancelled and an equivalent increase in capital investment therein. In the case of the subsidiaries a *pro tanto* reduction in their respective indebtedness to the petitioner was reflected at the time of the cancellations and additional issued stock was indicated.

The purpose of the cancellations was to enable the subsidiaries to obtain needed bank loans which were obtained after the cancellations. Subsequent advances from the petitioner to the subsidiaries were repaid in full. The petitioner and subsidiaries each filed separate tax returns in 1946.

Before the Tax Court, petitioner contended for a deduction of $650,000.00 in 1946 either as a bad debt, partial bad debt, business expense or loss. The Tax Court rejected the petitioner's contentions with respect to bad

[2] While the Tax Court made no finding of insolvency, it is apparent that the Tax Court regarded the subsidiaries as insolvent after cancellation by its holding that the debtor corporations did not receive income as the result of cancellation. Had the subsidiaries been rendered solvent by the cancellation the cancelled amount would have been income to them. Moreover, the Tax Court assumed that the sums due were uncollectible when cancelled. Similarly, the Court below also predicated its holding upon the assumption that the debtors were insolvent after as well as before the cancellations.

debt deduction, holding that petitioner made a capital contribution of $300,000.00 to Superior in 1946 and of $350,000.00 to Dutchess in that year. The Tax Court did not consider or decide the contentions with respect to partial bad debts, losses or business expenses.

The Court below affirmed the Tax Court, finding that the cancellation was a contribution to the capital of the subsidiaries and, hence, a capital contribution by the petitioner which precluded the petitioner from obtaining a bad debt deduction.

It is the petitioner's contention here that having met the statutory test for bad debt deductions such a right may not be stripped from it under a doctrine that the worthless debts are converted into capital contributions by voluntary cancellation. Moreover, the petitioner asserts that whatever the effect of the cancellations may have been upon the subsidiaries, the effect upon the petitioner need not be related; even if capital contributions to the debtors they need not be capital contributions by the petitioner. Finally, the effect of cancellation and issuance of new shares by the debtors was meaningless in any event, as the petitioner already owned all of the issued and outstanding shares of the subsidiaries at the time of cancellation.

Reasons for Granting the Writ

A. As grounds for requesting the issuance of a writ of certiorari the petitioner asserts a conflict of decisions between the decision below (Court of Appeals for the Second Circuit) and that of the Court of Appeals for the Fifth Circuit in *Giblin v. Commissioner*, 227 F. (2d) 692, decided November 23, 1955. The Court below recognized this fact when it stated with respect to the *Giblin* case: "insofar as the opinion expresses views opposed to our own we respectfully disagree with them." The

conflict between Courts of Appeal on this issue is further demonstrated by the fact that in the opinion below the Court relied upon *Bratton v. Commissioner* (CCA-6, 1955) 217 F. (2d) 486, which is also in conflict with *Giblin v. Commissioner, supra.* There is, therefore, a conflict of authority between the Courts of Appeals with the Fifth Circuit holding that cancellation does not destroy the right to a bad debt deduction while the Second and Sixth Circuits hold that cancellation necessarily results in capital contributions.

B. Bad debt cases are notoriously litigious and this is particularly true of disputes involving bad debt deductions *versus* capital contributions. In addition, the effect of "voluntary cancellation" in this type of situation is of wide interest and significance. The fact that three different Courts of Appeal have had to rule upon this proposition within the last year is evidence in itself of the importance of the problem. Its effect upon corporate taxpayers and their shareholders is of fundamental importance.

C. By holding that a voluntary cancellation of indebtedness (made at a time when the debts were uncollectible and worthless) constituted a capital contribution rather than allowing a deductible bad debt, the Court below vitiated the clear intent of Congress. The effect of the holding below may be referred to as the "conversion" concept, for it converts what would otherwise be an admitted bad debt situation into a capital contribution simply because of a "voluntary cancellation". While the word "convert" was not used by the Court below it was used by the Tax Court in its opinion involving this petitioner. It was also used and relied on in *Bratton v. Commissioner, supra,* which cites the Tax Court below as authority.

The difficulty with the opinion of the Court below (and by the same token with the Tax Court decision below as

well as with *Bratton v. Commissioner, supra*) is that once the statutory requirements for bad debt deduction have been met, no adequate justification is given for stripping a taxpayer of the right to such deduction just because of cancellation. Indeed, nothing in Code Section 23(k)(1) (1939 Code), the legislative history, or the Commissioner's Regulations suggests the possibility that a taxpayer can lose the right to a bad debt deduction once it has arisen. The Code section itself simply states that, "there shall be allowed as deductions debts which become worthless within the taxable year." This mandatory language is neither conditional nor qualified but is absolute. It is true, of course, that a deduction such as is here involved is a matter of legislative grace. Yet the legislative purpose is clear for in Congress it was stated, "the only fact of importance is that the debt actually did become worthless and the Bill makes this the sole test."[3] The petitioner submits, therefore, that the proper criterion for a bad debt deduction is simply the fact of worthlessness. And this is the only test. Cancellation neither gives the debt worth nor takes it away; it simply recognizes its worthlessness.

The apparent rationale of the opinion below—as it was in *Bratton v. Commissioner, supra*—was a conviction that a gratuitous release by a taxpayer of an obligation owed to it by a corporation of which it is a stockholder *necessarily* precludes it from claiming a deduction based on the existence of the bad debt.[4] This would mean that any cancellation of corporate indebtedness by stockholder, whether individual or parent corporation, would, *ipso facto*,

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[3] See comment by Mr. Disney in the floor discussion in the House reported in the *Congressional Record*, Vol. 88, p. 6377, 77th Cong., 2d Sess. See also H. R. 2333, Ways and Means Committee, p. 44, 77th Cong., 2d Sess.

[4] See comment on this point in *Giblin v. Commissioner, supra*.

have to be a contribution to capital in spite of the fact that at the time of such cancellation all of the prerequisite factors are present to justify a bad debt deduction.[5] Such a plenary prohibition cannot be justified by the authorities, as the well-reasoned opinion of the Court of Appeals for the Fifth Circuit in *Giblin v. Commissioner, supra,* pointed out. The same argument there (and it is the same argument espoused in *Bratton v. Commissioner, supra*) was rejected. For the same reasons that argument should be rejected here.

D. The legal effect upon the debtor should not control the legal effect upon the creditor where a cancellation of indebtedness occurs under circumstances such as existed here. The Court's opinion below, as well as the Tax Court's opinion below (and the opinion in *Bratton v. Commissioner, supra,* as well) all cite and rely upon Commissioner's Regulations promulgated as Treasury Regulations 111, Sec. 29.22(a)-13 having to do with cancellation of indebtedness. As the Fifth Circuit points out in *Giblin v. Commissioner, supra,* this Regulation deals with an *income* problem rather than a bad debt deduction problem. Moreover, in terms it is qualified to certain "general" situations. Finally, it would not apply in any event where after forgiveness the debtor corporation was still insolvent.

The Court below, as did *Bratton* v. *Commissioner, supra,* cited and relied on a number of cases, all of which relate to *debtors* rather than to creditors. For the same reasons explained by the Court in *Giblin* v. *Commissioner, supra,* petitioner here asserts that such authorities are inapposite.

That there is no necessary reciprocal relationship be-

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[5] Although the Tax Court made no finding of petitioner's intent when cancelling, the Court below saw an intent to contribute capital. This was based solely upon the formalities of stock issuance and book entries and ignores other countervailing evidence. Petitioner does not concede intent to contribute.

tween the effect of cancellation upon a debtor and a creditor has been ruled upon by lower courts. The Court below refused to acknowledge this distinction without any discussion or citation of authority. The related cases of *Cocheco Woolen Manufacturing Co.*, T. C. Memo Op., Docket No. 4175, entered June 28, 1945 and *George A. Adam*, T. C. Memo Op., Docket No. 1720, entered June 28, 1944, involve the debtor and creditor, respectively, in a cancellation situation. In the first case it was held that as to the debtor corporation, a gratuitously forgiven debt was a capital contribution by gift while in the second case relating to the stockholder-creditor a bad debt deduction was allowed.[6]

The use of the phrase "voluntary cancellation" in the opinion below (as well as in the Tax Court below) is singularly inappropriate. No doubt it is derived from the fact that both courts, having concluded that there was no difference between the tax effect upon a debtor and a creditor where a cancellation had occurred, seized upon the "voluntariness" to connote a gift by way of capital contribution. The inescapable difficulty with such a concept, however, is that where by supposition the debts cancelled were themselves already worthless, nothing of value could be contributed. Nearly every authority cited by the Court below involved not only debtors rather than creditors but, moreover, each case involved valuable collectible debts and not, as here, admittedly worthless and uncollectible claims.

E. The cancellation of worthless debts and issuance of worthless stock therefor by wholly-owned subsidiaries of petitioner were in substance meaningless acts and should have no tax consequence here. Clearly, there is no requirement in the statute for cancellation of debts in order to obtain the benefit of a bad debt deduction. Conversely, there is nothing in the statute which makes such cancellation a

[6] See also *The Securities Co.* v. *U. S.* (DC NY, 1948) 85 F. Supp. 532.

bar to such deduction. If the debts have become worthless the deduction follows. The fact of worthlessness turns upon the debtor's inability to repay. Normally, therefore, the books of neither the debtor nor the creditor need be altered in any form to validate the right to a bad debt deduction. Here, the formalities of cancellation and issuance of more stock did occur. But neither event has true significance. Legal liabilities which the subsidiaries could not repay were extinguished. Nothing of value was contributed to Superior or Dutchess.[7] As to the petitioner, the cancellation and receipt of stock merely evidenced the termination of a debt which it could not collect in any event, together with a dilution of its stock ownership in its subsidiaries which were already wholly owned and the stock of which was, by assumption, also worthless. Petitioner was still out of pocket $650,000.00.

With respect to this matter, the Court below disagreed, pointing out that petitioner "retained his 100 percent right to future dividends." Yet petitioner already had a 100 percent right to future dividends before cancellation and even without the additional shares. The Court below also points out that "if the cancelled debts had any value whatever, to that extent" petitioner increased its capital investment. Yet at the time the Court below was willing to assume for the purposes of its holding that debtors were insolvent after as well as before cancellation. Thus the debts had no value. Finally, the Court below found that wiping out the subsidiaries' debts was a "valuable contribution to the financial structure of the subsidiaries." Presumably the Court refers to the elimination of indebtednesses and the substitution of increased capital stock on the balance sheets. Yet even so, both subsidiaries were by the Court's own hold-

[7] *Hughes Tool Co.* (1939) 40 B.T.A. 963, 970; affd. (CCA-5, 1941) 118 F. (2d) 472.

ing still insolvent and the stock still worthless. It is difficult to perceive why such a valueless contribution should be dispositive. In any event, as noted *supra*, the effect of the cancellation upon the debtor corporation has no necessary effect upon the right of the creditor corporation to bad debt deduction.

Conclusion

This petition for writ of certiorari should be granted.

Respectfully submitted,

FRED R. TANSILL,
Counsel for Petitioner,
824 Connecticut Avenue, N. W.,
Washington 6, D. C.

Of Counsel,
GOODWIN, ROSENBAUM, MEACHAM & WHITE,
Washington 6, D. C.

APRIL, 1956.

APPENDIX A

STATUTE INVOLVED

INTERNAL REVENUE CODE (of 1939):

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

• • • • • • •

"(k) BAD DEBTS.—

"(1) GENERAL RULE.—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. • • •"

APPENDIX B

UNITED STATES COURT OF APPEALS, FOR THE SECOND CIRCUIT

No. 31—October Term, 1955.

Argued December 6, 1955 Decided January 17, 1956.

Docket No. 23533

LIDGERWOOD MANUFACTURING CO., Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Before: SWAN, FRANK and LUMBARD, *Circuit Judges.*

On Petition to Review a Decision of the Tax Court of the United States.

The taxpayer seeks review of a decision of the Tax Court which sustained the Commissioner's determination of a deficiency in income tax for the year 1946. Affirmed.

Francis E. H. Davies, Attorney for Petitioner; Fred R. Tansill and Goodwin, Rosenbaum, Meacham & White, of Counsel.

H. Brian Holland, Assistant Attorney General, Ellis N. Slack, Hilbert P. Zarky and Frank E. A. Sander, Special Assistants to the Attorney General, for Respondent.

SWAN, *Circuit Judge:*

The question presented by this appeal is whether the Tax Court erred in holding that the taxpayer's cancellation in 1946 of debts owed to it by two subsidiary corporations, whose stock was wholly owned by it, constituted capital contributions to the subsidiaries and precluded deduction as worthless debts of the amounts, aggregating $650,000, so cancelled. Disallowance of the bad debt claims resulted in the deficiency complained of.

The findings of fact and opinion of the Tax Court are reported in 22 T. C. 1152. For present purposes an abbreviated statement will suffice. In 1946 the petitioner, a New York corporation, had two wholly owned subsidiary corporations. They will be referred to respectively as Superior and Dutchess. On October 31, 1946 Superior owed its parent corporation some $411,000, and on that date the parent voluntarily canceled $300,000 of the indebtedness, at the same time receiving 3500 shares of Superior's common stock. On three occasions during 1946, the petitioner likewise cancelled debts owed to it by Dutchess and received in exchange shares of the debtor's common stock. Each of the debts at the date when cancelled was uncollectible. Appropriate entries in the books of the respective corporations were made to reflect reduction in indebtedness of the subsidiaries and increase in capital investment by

the parent. The purpose of the debt cancellations was to enable the subsidiaries to obtain needed bank loans, which they did obtain after the cancellations. They also obtained further advances from the petitioner, which have been repaid in full. The parent and both subsidiaries filed separate tax returns in 1946. The petitioner's return, as originally filed, reported a net income, showed an increase during the year in the amount invested in its subsidiaries, and claimed no deduction for bad debts. By amendments a bad debt deduction of $650,000 was claimed.

Some of the facts above stated are "assumed" by the Tax Court instead of expressly found.[1] On the basis of the facts found and assumed the Tax Court held that the petitioner made a capital contribution of $300,000 to Superior in 1946 and of $350,000 to Dutchess in that year. We think the decision correct.

The cancellation of indebtedness by a creditor may be either a gift, a contribution to capital, if the debtor be a corporation, or a sale of a claim for less than its face value. Determination of which category a particular transaction falls into depends on the facts of the particular case, and largely on the intent of the creditor.[2] This court and others have held that cancellation of a debt owed by a corporate debtor to a stockholder of the debtor does not constitute taxable income to the debtor but is a capital contribution by the creditor.[3] For many years the Treasury Regula-

[1] The opinion of Judge Rice states:

"Assuming the advances to be loans when made, which petitioner expected to be fully repaid and assuming also that the sums due were uncollectible when canceled, the petitioner's voluntary cancellation of the 'debts' converted them into a capital contribution. * * *"

[2] See *Commissioner* v. *Jacobson*, 336 U. S. 28, 50: "In the absence of proof to the contrary, the intent of the seller [creditor] may be assumed to have been to get all he could for his entire claim."

[3] *Commissioner* v. *Auto Strop Safety Razor Co.*, 2 Cir., 74 F. 2d 226, cited with apparent approval in *Helvering* v. *American Dental Co.*, 318 U. S. 322, 328; *Carroll-McCreary Co.* v. *Commissioner*, 2 Cir., 124 F. 2d

tions have so provided.[4] It is true, as the petitioner says, that the Regulations, as well as the cited authorities, with the exception of the *Bratton* and *Olds* cases, were directed to determining whether the debtor received taxable income by reason of cancellation of the indebtedness. But we cannot see the relevancy of this alleged distinction. If the debtor has received a contribution to capital, the creditor must have made the contribution. Consistency requires that both parties treat it alike. Whether the creditor's investment will result in profit or loss to the investor cannot be determined forthwith. Loss, if any is eventually realized, occurs when the investment is closed out; that is, when the shares of stock of the debtor are sold or become worthless.[5]

The petitioner contends that since the debts were assumed to be uncollectible, the cancellation of worthless debts and the issuance of stock therefor were meaningless formalities. We disagree. When a creditor cancels a debt in return for stock, he gives up the right to repayment, however prosperous the debtor may become, and he acquires a right to dividends from future prosperity. If he owns less than all of the debtor's stock, the issuance of additional shares increases his share of possible dividends. If, as here, the creditor owns all the debtor's stock, his share is not in-

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303; *Cream Bros.* v. *Commissioner*, 3 Cir., 195 F. 2d 257; *Bratton* v. *Commissioner*, 6 Cir., 217 F. 2d 486; *Olds* v. *Commissioner*, 18 B. T. A. 1215; additional citations may be found in the Tax Court's opinion, 22 T. C. 1152.

[4] Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, provides:

> "Sec. 29.22(a)-13. *Cancellation of Indebtedness*—In general. • • • In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt. • • •"

[5] See *Estate of Mallory* v. *Commissioner*, 27 B. T. A. 750. This was also the view of Judge Rice in the case at bar.

creased but he has retained his 100 per cent right to future dividends, and, if the cancelled debts had any value whatever, to that extent he has increased his capital investment. It is not entirely clear what the Tax Court meant by its assumption that the debts were "uncollectible." Although the petitioner had contended that the subsidiaries were insolvent both before and after the cancellations, no finding of insolvency was made. But even on the assumption that the debtors were insolvent after as well as before the cancellations, wiping out the debts was a valuable contribution to the financial structure of the subsidiaries.[6] It enabled them to obtain bank loans, to continue in business and subsequently to prosper. This was the avowed purpose of the cancellations. Where a parent corporation *voluntarily* cancels a debt owed by its subsidiary in order to improve the latter's financial position so that it may continue in business, we entertain no doubt that the cancellation should be held a capital contribution and preclude the parent from claiming it as a bad debt deduction. That the petitioner intended it to be a capital contribution is clear, for it not only received stock in exchange for the cancellations but made entries in its books to reflect the transaction as such. *Bratton* v. *Commissioner*, 6 Cir., 217 F. 2d 486 is an authority in point. We agree with it. *Giblin* v. *Commissioner*, 5 Cir., F. 2d (November 23, 1955) may be distinguishable on the facts; in so far as the opinion expresses views opposed to our own we respectfully disagree with them.

The taxpayer's alternative argument that it was entitled to a deduction for partially worthless bad debts, business losses or business expenses was not considered by the Tax Court, nor need we consider it. Decision affirmed.

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[6] A similar situation existed in *Bratton* v. *Commissioner*, 6 Cir., 217 F. 2d 486, where the court found the debtor to have been insolvent through 1950 and held that the creditor's voluntary cancellation of indebtedness during that year was a contribution to capital.

APPENDIX C

UNITED STATES COURT OF APPEALS, SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 17th day of January one thousand nine hundred and fifty-six.

Present: Hon. Thomas W. Swan, Hon. Jerome N. Frank, Hon. J. Edward Lumbard, Circuit Judges.

LIDGERWOOD MANUFACTURING CO., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

(S.) A. DANIEL FUSARO,
Clerk.

APPENDIX D

FINDINGS OF FACT AND OPINION

22 T. C. No. 141

THE TAX COURT OF THE UNITED STATES

LEDGERWOOD MANUFACTURING CO., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 35193

Filed August 31, 1954

In 1946, upon receipt of additional capital stock therefor, petitioner voluntarily canceled $650,000 of alleged indebtedness owed to it by its two wholly-owned subsidiaries. Book adjustments were made reflecting the discharge of indebtedness and the increase in capital investment. The purpose of the debt cancellation was to enable the subsidiaries to obtain needed bank loans. Petitioner made advances to both subsidiaries after the cancellation. Such subsequent advances were repaid in full, and both subsidiaries continued to prosper. On an amended return for 1946 and by amended petition in this proceeding, petitioner claimed a bad debt deduction for the amount of the debts canceled.

Held, the voluntary cancellation of indebtedness was an additional capital contribution by petitioner to its two subsidiaries, and no deduction is allowable for a bad-debt loss, in whole or in part, or for a business loss or business expense.

Eugene Meacham, Esq. and *Fred R. Tansill, Esq.* for the petitioner.

Ellyne E. Strickland, Esq. for the respondent.

This proceeding involves deficiencies in taxes as follows:

Year	*Tax*	*Amount*
1944	Income	—0—
	Excess Profits	$573,646.89
1945	Income	8.01
	Excess Profits	79,785.37
1946	Income	248.90

The issues to be determined are: (1) whether petitioner is entitled to a deduction of $650,000 or some part thereof, in the year 1946, for alleged bad debts which became worthless or partially worthless or for a business loss or expense, when the amount so claimed *arose* from the cancellation of purported loans and advances made by petitioner to its 2 wholly-owned subsidiaries; and (2) if so, whether in computing net operating losses for 1946 and 1947 and resulting carry-backs to 1944 and 1945, petitioner is entitled to include, under section 122 (d) (6) of the Internal Revenue Code of 1939, excess profits taxes for 1945 which were paid in 1946 and 1947; and (3) whether petitioner, in computing the amount of a net operating loss carry-back from 1946 to the taxable year 1945, is entitled to reduce the 1944 net income by the amount of excess profits tax liability shown on its 1944 return, under the provisions of section 122 (b) (1) (A) of such Code.

Some of the facts were stipulated.

Findings of Fact

The stipulated facts are so found and are incorporated herein by this reference.

Lidgerwood Manufacturing Company (hereinafter referred to as Lidgerwood or the petitioner) is a New York corporation with principal offices in New York City, New York. It maintained its books and records and filed its Federal tax returns on the accrual method of accounting for the calendar years 1944, 1945, and 1946.

Separate income and excess profits tax returns for 1944

and 1945 were filed with the collector of internal revenue for the fifth district of New Jersey. A separate return and amended return for 1946 were filed with the collector for the second district of New York.

During the years in question, Lidgerwood manufactured hoisting machinery and marine auxiliaries, such as steering gears, windlasses, and deck machinery. Its principal plant was at Elizabeth, New Jersey. Its capital stock was wholly owned by one Louis D. Tenerelli.

On November 2, 1940, Lidgerwood acquired, and held during the years in question, all of the outstanding common stock of the Superior Iron Works Company (hereinafter referred to as Superior), a Wisconsin corporation located at Superior, Wisconsin.

On July 31, 1945, Lidgerwood acquired, and thereafter held, all of the outstanding common stock of the Dutchess Tool Company, Inc. (hereinafter referred to as Dutchess), a New York corporation, located at Beacon, New York. On September 10, 1945, the corporation's name was changed to Dutchess Bakers' Machinery Company, Inc.

Prior to World War II, Dutchess had manufactured bakers' machinery. During the War, it manufactured telemotors, used to actuate the steering mechanisms on ships. During the War, Superior and Lidgerwood manufactured materiel similar to that which they normally manufactured.

Dutchess required extensive retooling after the War in order to resume the manufacture of bakers' machinery. While the retooling was in progress during the latter part of 1945 and in 1946, the officers of Lidgerwood decided that Dutchess should manufacture 3 new products; a vibrating hair brush, an electric heater, and an air-purifying machine. Separate subsidiary corporations, owned by Dutchess, were organized to develop each product. Lidgerwood advanced money to Dutchess to help in the development of the 3 products. Each product, however, proved to be a failure.

On May 27, 1946, Lidgerwood's books showed a balance

due from Dutchess of $136,224.44. The principal amount of such indebtedness resulted from advances for the development of the hair brush, which by that time had proved a failure. Dutchess offered to issue 1,250 shares of its common stock to Lidgerwood if petitioner would cancel $100,000 of the indebtedness due it. Lidgerwood agreed. Its books thereafter reflected an increase in its investment in Dutchess of $100,000 and a corresponding reduction of the amount due from Dutchess. Dutchess' books reflected similar account adjustments by increases in the amount of outstanding capital stock and reduction of accounts payable.

Lidgerwood continued to advance money to Dutchess. On August 31, 1946, its books showed indebtedness due from Dutchess of $106,218.62. A substantial part of such amount resulted from advances by Lidgerwood to aid in the development of the electric heater, which by that time had proved to be a failure. Dutchess offered to issue 1,000 shares of its common stock to Lidgerwood if petitioner would cancel $50,000 of the indebtedness due it. Lidgerwood agreed, and appropriate adjustments were made to reflect the cancellation of that part of the debt and the corresponding issuance of stock.

Lidgerwood continued to make advances to Dutchess. On October 31, 1946, its books showed indebtedness due from Dutchess of $271,072.41. A substantial part of such sum resulted from advances for the development of the air-purifying machine, which by that time had also proved to be a failure. Dutchess offered to issue 2,750 shares of its common stock to Lidgerwood if petitioner would cancel $200,000 of the indebtedness due it. Lidgerwood agreed, and appropriate book adjustments were made to reflect the debt cancellation and stock issuance.

Lidgerwood thereafter continued to advance substantial amounts of money to Dutchess.

As part of its postwar plans, Lidgerwood decided that

Superior should undertake the manufacture and sale of bituminous coal-burning stokers. The program was begun in 1945. Superior contracted with Westinghouse Electric & Manufacturing Company for the electric motors for its stokers. Early in January 1946, employees of Westinghouse went on strike and production at its plants was not resumed until late in the Spring. Superior was unable to get motors from any other source. Shortly after the end of the Westinghouse strike, the United Mine Workers went on strike. General public doubt as to the availability of coal resulted in the cancellation of many orders for stokers. Because of the 2 strikes and the delayed production caused thereby, Superior's stoker program proved to be a failure by the Fall of 1946. Lidgerwood advanced substantial sums to Superior; and, on October 30, 1946, Superior owed Lidgerwood $411,722.85.

Early in 1946, it became apparent to Lidgerwood that its cash position and that of its subsidiaries was very tight, principally because of some $900,000 of Federal tax and renegotiation liabilities. Repeated efforts were made in behalf of Dutchess and Superior to secure loans from banks or insurance companies. Those efforts failed, always because of the large amount of indebtedness which the 2 subsidiaries owed to Lidgerwood. Banks suggested that loans might be made if Lidgerwood would agree to subordinate its own indebtedness to the bank loans proposed.

Because of the need for cash, Lidgerwood decided to sell its own plant, and to operate thereafter through Superior and Dutchess. On July 17, 1946, it contracted with The Trailmobile Company for the sale of its plant for $700,000. Lidgerwood agreed to vacate the premises by November 1, 1946. From July 17 to October 31, 1946, Lidgerwood shipped to Superior machinery and equipment of various kinds, having a depreciated value of $166,645.94. That amount was reflected on the books of Superior and Lidger-

wood as loans and advances payable and receivable, respectively. During the same period, Lidgerwood made two $25,000 advances to Superior. A substantial part of such sums was used by Superior to pay freight and other costs incident to the shipment of the machiney and equipment. Lidgerwood also transferred machinery having a net book value of $15,074.08 to Dutchess during this period. This transfer was also recorded as a loan payable to Lidgerwood on the books of Dutchess.

Lidgerwood, at the time its plant was sold, had some $682,107.63 of incompleted contracts. These were transferred to Superior and Dutchess for completion.

The large inventories which had been built up during the development of products which proved to be a failure were also a factor responsible for the inability of Superior and Dutchess to obtain bank loans prior to October 31, 1946.

In addition to the cancellation of $200,000 of indebtedness of Dutchess on October 31, 1946, Lidgerwood also on that date canceled $300,000 of the total amount of $411,722.85 owed to it by Superior and received 3,500 shares of Superior's common stock. The books of the two companies reflected the reduction in open accounts and increase in capital stock investment.

The balance sheets of Superior and Dutchess thereafter reflected the reduced indebtedness which the two companies owed to Lidgerwood, and bank loans were obtained. Lidgerwood also continued to advance money to the two companies, which was repaid. Both companies continued to prosper after October 31, 1946.

On its income tax return for 1946, filed on June 16, 1947, Lidgerwood reported net income of $168,952.34. It also showed an increase of $647,744 during the year in the amount invested in subsidiaries. It claimed no deduction for bad debts or losses. In an amended return, filed on September 21, 1948, it reported a net loss for 1946 of

$346,401.72. In a rider to the amended return, it claimed a loss due to cancellation of indebtedness as follows:

Superior Iron Works Company	$65,354.06
Dutchess Bakers Machinery Co., Inc.	350,000.00

The respondent disallowed such deductions for bad debts in determining the deficiencies herein. By amended petition, petitioner alleged that the amount which should be allowed it for a bad-debt deduction in 1946 is $650,000.

Petitioner made a capital contribution in the amount of $300,000 to Superior in 1946 and of $350,000 to Dutchess in that year.

Opinion

Rice *Judge:* The petitioner introduced extensive evidence into the record with reference to the history of the corporation, detailed descriptions of the 3 new products manufactured by Dutchess, and to the stoker program of Superior. It also introduced evidence to support its allegation that the 2 subsidiaries were insolvent and unable to pay the indebtedness canceled. Petitioner requested that we make a number of specific findings of fact on those and other matters.

We have carefully reviewed all of the documentary evidence presented as well as the testimony of the petitioner's witnesses. Many requested findings have been omitted, for, while interesting, many of those facts and other items of information are extraneous and irrelevant; and their inclusion would only serve to obscure the significance of those facts which we have found and which are necessary to the decision of the question presented.

Petitioner has attempted to show that the $650,000 of indebtedness owed to it by Superior and Dutchess was a totally worthless and uncollectible bad debt, which it canceled in 1946 and argues that it is entitled to an appropriate

deduction therefor. As an alternative argument, it has attempted to show that a part of the amount canceled was a partially worthless bad debt, a business loss or a business expense.

Obviously, a "loss", in the generic sense, cannot be both a "bad debt" and a "business loss". *Spring City Foundry Co.* v. *Commissioner*, 292 U. S. 182 (1934). But the petitioner is not precluded from arguing both theories in the hope of showing the applicability of one of them to the facts presented.

In support of his determination that no part of the amount canceled should be allowed as a bad debt or loss, respondent argues: (1) that the advances by petitioner were capital contributions to Superior and Dutchess when made; (2) assuming the advances to be loans, they were not proved to be worthless; and (3) if the advances were loans when made, they became capital contributions when they were canceled and stock of the subsidiaries issued therefor.

On the basis of the record before us, we think that considerable support could be found for respondent's first two arguments. We pass them, however, because his third argument presents a complete bar to petitioner's deduction of the canceled indebtedness on any of the theories it has advanced.

Assuming the advances to be loans when made, which petitioner expected to be fully repaid and assuming also that the sums due were uncollectible when canceled, the petitioner's voluntary cancellation of the "debts" converted them into a capital contribution. *Commissioner* v. *Auto Strop Safety Razor Co., Inc.*, 74 F. 2d 226 (C.A. 2, 1934); *Johnson, Drake & Piper* v. *Helvering*, 69 F. 2d 151 (C.A. 8, 1934), certiorari denied 292 U.S. 650 (1934), affirming 27 B.T.A. 585 (1933); *United States* v. *Oregon-Washington R. & Nav. Co.*, 251 F. 211 (C.A. 2, 1918); *Estate of L. W. Mal-*

lory, 27 B.T.A. 750 (1933): *Franklin Q. Brown, et al.*, 9 B.T.A. 965 (1927). Gratuitous forgiveness of a debt is no ground for a claim of worthlessness. *George F. Thompson*, 6 T.C. 285 (1946) affd. 161 F. 2d 185 (C.A. 2, 1947); *W. D. Haden Co.* v. *Commissioner*, 165 F. 2d 588 (C.A. 5, 1948); *W. F. Taylor Co.*, 38 B.T.A. 551 (1938).

The *Auto Strop Safety Razor Co., Inc.*, case, of course, concerns the converse of the problem presented here; viz., the tax consequences of cancellation of indebtdness to the debtor. It is impossible for us to see, however, how the consequences to the debtor and the creditor can differ. In either instance it is the voluntary act of the creditor-stockholder which determines the character of the transaction.

The cancellation of the debt is not income to the debtor corporation; it increases the paid-in capital of the debtor and correspondingly increases the basis of the creditor-stockholders' shares. Loss, if any is eventually realized, occurs at the time such shares are sold or become totally worthless.

We are satisfied that the only purpose which motivated petitioner's voluntary cancellation of the indebtedness was the desire to secure additional loans from banks. Certainly every book entry was made, as well as actual stock certificates issued, to reflect the cancellation in every possible way as a voluntary contribution to capital.

Petitioner's owner, Louis Tenerelli, testified that the advances of money to both companies and the value of the machinery transferred were transactions which, when made, created debts and that petitioner always expected to be repaid in full. He also testified that petitioner was loathe to cancel the "debts", but that he and its officers "went to the limit of our capacity in trying to save [Superior and Dutchess]" and that without such drastic action, all of the companies would have failed.

Be that as it may, it does not alter the fact that the voluntary cancellation by petitioner, no matter how reluctantly made, converted previous loans into additional capital investments by it in the 2 companies.

Our determination of the first issue raised in this proceeding makes unnecessary our consideration of the other two issues raised.

We granted petitioner's motion of May 25, 1954, to file an amendment to its second amended petition. Such amendment alleged that:

> * * * should the Court sustain the Commissioner by determining that there was no net operating loss in the year 1946 and that there was net income in 1946, then the Commissioner erred by failing to allow a net operating loss deduction in the year 1946 in the sum of $2,307.74, being the agreed amount of the net operating loss incurred by the petitioner in the year 1948.

Respondent denied such allegation. No evidence was offered by petitioner to substantiate a 1948 net operating loss carryback, and no deduction therefor from 1946 income will be allowed.

Decision will be entered for the respondent.

APPENDIX B

Decision

THE TAX COURT OF THE UNITED STATES
WASHINGTON

Docket No. 35193

LIDGERWOOD MANUFACTURING COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Decision

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed August 31, 1954, it is

ORDERED AND DECIDED: That there are deficiencies in tax, as follows:

Year	*Tax*	*Amount*
1944	Income	.....
	Excess Profits	$573,646.89
1945	Income	8.01
	Excess Profits	79,785.37
1946	Income	248.90

Enter: Entered Sep. 3, 1954.

(Signed) STEPHEN E. RICE, *Judge.*

(8290-9)